

PORTERFIELD & CO.

Review Report

QUALITY CONTROL REVIEW

For the Firm's Audit of
Lagunitas Elementary School District
for the Fiscal Year Ended June 30, 2002



STEVE WESTLY
California State Controller

September 2004



STEVE WESTLY
California State Controller

September 20, 2004

Mr. Gary S. Jones
Porterfield & Co.
1130 Iron Point Road, Suite 135
Folsom, CA 95630-8301

Dear Mr. Jones:

The State Controller's Office completed a quality control review of Porterfield & Co. We reviewed the audit working papers for the firm's audit of Lagunitas Elementary School District for the fiscal year ended June 30, 2002.

A draft report was issued on July 14, 2004. The firm's response to the draft report is included in this final report.

If you have any questions, please contact Casandra Moore-Hudnall, Chief, Financial Audits Bureau, at (916) 322-4846.

Sincerely,

"original signed by"

VINCENT P. BROWN
Chief Operating Officer

VPB:JVB/ams

cc: Mary Buttler, Superintendent
Lagunitas Elementary School District
Mary Burke, County Superintendent of Schools
Marin County Office of Education
Arlene Matsuura, Educational Consultant
School Fiscal Services Division
California Department of Education
Charles Pillsbury
School Apportionment Specialist
Department of Finance

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Review Report

Summary

The State Controller's Office (SCO) completed a quality control review of the audit working papers for an audit performed by Porterfield & Co. of the Lagunitas Elementary School District for the fiscal year ended June 30, 2002. The last day of fieldwork was August 12, 2003.

The audit referred to above was performed in accordance with some elements of the standards and requirements set forth in *Government Auditing Standards*, issued by the Comptroller General of the United States, often referred to as generally accepted government auditing standards (GAGAS); U.S. generally accepted auditing standards (GAAS); and the *Standards and Procedures for Audits of California K-12 Local Educational Agencies* (K-12 Audit Guide), published by the SCO. However, the majority of auditing standards and requirements were not met. The basis for this opinion is that the firm did not comply with general, fieldwork, and reporting standards. Also, the testing of state compliance requirements pursuant to the K-12 Audit Guide was not adequately documented by the firm.

Background

Any governmental unit subject to a single audit must have the audit performed in accordance with the standards referred to in this report. According to OMB Circular A-133, the auditor's work is subject to a quality control review at the discretion of an agency granted cognizant or oversight status by the federal funding agency. In addition, *Education Code* Section 14504.2 authorizes the SCO to perform quality control reviews of working papers for audits of K-12 local educational agencies (LEAs) to determine whether audits are performed in accordance with U.S. General Accounting Office standards for financial and compliance audits.

Porterfield & Co. is an independent certified public accounting firm with an office located in Folsom, California. The firm consists of three partners. Two perform tax service and one is responsible for school district and non-profit work. The firm has been the independent auditor for Lagunitas Elementary School District since fiscal year (FY) 1992-93. During FY 2001-02, the district operated one elementary school serving kindergarten through 8th grade, with a total average daily attendance (ADA) of 302 for the purpose of state funding.

Objectives, Scope, and Methodology

The general objectives of the quality control review were to determine whether this audit was conducted in compliance with:

- GAGAS
- GAAS
- K-12 Audit Guide

The quality control review was conducted at the office of Porterfield & Co. The SCO reviewers compared the audit work performed by the firm, as documented in the working papers, with the standards stated in the general objectives.

Conclusion

The audit referred to above was performed in accordance with some elements of the standards and requirements set forth in GAGAS, GAAS, and the K-12 Audit Guide; however, the majority of auditing standards and requirements were not met. The basis for this opinion is discussed in the Findings and Recommendations section of this report.

This report is applicable solely to the audit working papers referred to above and is not intended to pertain to any other work of Porterfield & Co.

Views of Responsible Official

The SCO issued a draft report on July 14, 2004. Porterfield & Co. responded by the attached letter dated August 10, 2004, disagreeing with the review results with the exception of Finding 1. The response is included in this final report as the Attachment.

Restricted Use

This report is intended solely for the information and use of the specified parties; it is not intended to be and should not be used for any other purpose. This restriction is not meant to limit distribution of the report, which is a matter of public record.

“original signed by”

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

Findings and Recommendations

General

The Single Audit Act and the *Standards and Procedures for Audits of K-12 Local Educational Agencies* (K-12 Audit Guide), published by the SCO, require audits to be performed in accordance with U.S. generally accepted auditing standards (GAAS). These standards deal with the quality of the audits performed by the independent auditor and have been approved and adopted by the American Institute of Certified Public Accountants (AICPA). GAAS is divided into three areas: (1) general standards; (2) fieldwork standards; and (3) reporting standards. The three areas are divided into ten specific standards. In addition to GAAS, auditors of governmental entities must also perform audits in accordance with generally accepted government auditing standards (GAGAS), which expands the GAAS standards in several areas.

In the course of this quality control review, the SCO reviewers found that Porterfield & Co. did not comply with the majority of the GAAS and GAGAS standards.

In addition, the firm did not adequately document testing of the state compliance requirements found in the K-12 Audit Guide.

Noncompliance With General Standards and Fieldwork Standards (GAAS, GAGAS, and K-12 Audit Guide)

FINDING 1— Payroll not tested and service organization not considered

The firm did not perform any substantive testing for payroll. Subsequent discussion with the firm indicated that the Marin County Office of Education processes the district's payroll. However, the firm did not review payroll even though the district initiates the payroll.

In addition, the firm did not comply with standards with regard to consideration of controls at the Marin County Office of Education. The Marin County Office of Education reviews and distributes all disbursements, maintains and processes payroll, and maintains the general ledger system for the district. The district only has the capability of inputting data into the system. The firm did not review the audit report of the Marin County Office of Education.

AU Section 324.12 states:

A service auditor's report on controls placed in operation at the service organization should be helpful in providing a sufficient understanding to plan the audit of the user organization. Such a report, however, is not intended to provide any evidence of the operating effectiveness of the relevant controls that would allow the user auditor to reduce the assessed level of control risk below the maximum. Such evidential matter should be derived from one or more of the following:

- a. Tests of the user organization's controls over the activities of the service organization (for example, the user auditor may test the user organization's independent re-performance of selected items processed

by an EDP service center or test the user organization's reconciliation of output reports with source documents)

b. A service auditor's report on controls placed in operation and test of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

c. Appropriate tests of controls performed by the user auditor at the service organization.

AU Section 324.13 states:

The user organization may establish effective controls over the service organization's activities that may be tested and that may enable the user auditor to reduce the assessed level of control risk below the maximum for some or all of the related assertions. If a user organization, for example, uses an EDP service center to process payroll transactions, the user organization may establish controls over input and output data to prevent or detect material misstatements. The user organization might re-perform the service organization's payroll calculations on a test basis. In this situation, the user auditor may perform tests of the users organization's controls over data processing that would provide a basis for assessing control risk below the maximum for the assertions related to payroll transactions. The user auditor may decide that obtaining evidence of the operating effectiveness of the service organization's controls, such as those over changes in payroll programs, is not necessary or efficient.

AU Section 324.15 states:

The user auditor's assessments of control risk regarding assertions about account balances or classes of transactions are based on the combined evidence provided by the service auditor's report and the user auditor's own procedures. In making these assessments, the user auditor should consider the nature, source, and interrelationships among the evidence, as well as the period covered by the tests of controls. The user auditor uses the assessed levels of control risk, as well as his or her understanding of internal control, in determining the nature, timing, and extent of substantive tests for particular assertions.

Recommendation

The firm should test payroll to ensure that the information provided to the Marin County Office of Education is valid and accurate. In addition, the firm should comply with GAAS with regard to the consideration of a service organization's impact on its auditee's operations and controls.

Firm's Response

The finding, for the year ended June 30, 2002, is correct.

**FINDING 2—
Sampling deficiencies**

The firm did not document the sampling methodology in the working papers. Additionally, the working papers do not justify or document the rationale for the size of the sample selected or how the sample relates to the universe or population size, the account balance, class of transactions, and other relevant audit evidence.

AU Section 350.23 states:

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should consider the tolerable misstatement, the allowable risk of incorrect acceptance, and the characteristics of the population. An auditor applies professional judgment to relate these factors in determining the appropriate sample size.

AU Section 350.16 states:

When planning a particular sample for a substantive test of details, the auditor should consider . . . characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

AU Section 350.24 states:

Sample items should be selected in such a way that the sample can be expected to be representative of the population.

AU Section 350.29 states:

The auditor should relate the evaluation of the sample to other relevant audit evidence when forming a conclusion about the related account balance or class of transaction.

The K-12 Audit Guide also requires the auditor to select samples that are representative of the population to be tested in several state compliance programs such as attendance reporting, kindergarten continuation, independent study, continuation education, etc.

Sample sizes may not be adequate or reflective of the related account balance or class of transactions. Consequently, conclusions reached about the fairness of account balances, transactions, or compliance with state requirements may be incorrect.

Recommendation

In selecting a sample, the firm should not only comply with GAAS and the K-12 Audit Guide requirements and use a method that considers population characteristics such as size, account balance, transaction class, and other variables such as tolerable misstatement, allowable risk of incorrect acceptance, and control risk assessment, but should also document that methodology. Furthermore, the firm should document that the sample selection is representative of the population.

Firm's Response

We did not document the sampling methodology; however, we used professional judgment in the testing. The district is small and for attendance, for example, we tested a representative sample of teachers and grades. For the balance sheet and revenue accounts, we did no sampling as we audited the details.

SCO's Comment

The firm's working papers did not document the sampling methodology, the auditor's justification or rationale for the size of the sample selected, how the sample related to the universe or population size, the account balance, class of transactions, or other relevant audit evidence as required by GAAS and GAGAS.

In addition, the working papers reviewed did not reflect 100% verification of the balance sheet and revenue account detail.

GAGAS 4.35 states:

Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments.

GAGAS 4.37 states:

Working papers should contain

- a. the objectives, scope, and methodology, including any sampling criteria used; and
- b. documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records; and evidence of supervisory reviews of the work performed.

The finding remains as written.

**FINDING 3—
Evidential matter
deficiencies—K-12
Audit Guide**

The working papers do not contain evidence that all K-12 Audit Guide procedures were performed. The auditor initialed the K-12 Audit Guide to indicate that procedures were performed, but there was little to no documentation to support the testing, samples selected, and conclusions reached by the auditor in the following areas:

- Staff Development
- Incentives for Longer Instructional Day
- Class Size Reduction
- Instructional Materials Fund
- California Public School Library Act

GAGAS 4.35 states:

Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them evidence that supports the auditors' significant conclusions and judgments.

GAGAS 4.36 states:

Audits done in accordance with GAGAS are subject to review by other auditors and by oversight officials more frequently than audits done in accordance with AICPA standards. Thus, whereas AICPA standards cite two main purposes of working papers—providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit—working papers serve an additional purpose in providing the reviewer written documentation of the evidence supporting the auditors' significant conclusions and judgments.

AU Section 339.01 states, in part:

The auditor should prepare and maintain audit documentation [working papers], the form and content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of auditing procedures applied, evidence obtained and conclusions reached by the auditor in the engagement. . . .

AU Section 339.03 states:

Audit documentation [working papers] serves mainly to:

- a. Provide principal support for the auditor's report, including the representation regarding the observance of standards of fieldwork, which is implicit in the reference in his report to generally accepted auditing standards.
- b. Aid the auditor in the conduct and supervision of the audit.

Noncompliance may not be detected if state compliance procedures are not adequately or accurately performed. In addition, the independent auditor's report is incorrect because the auditor did not perform the audit in accordance with GAAS and GAGAS as stated in the report.

Recommendation

The firm should ensure that the working papers provide sufficient documentation to support the auditor's conclusions and judgments. The firm should comply with GAGAS and GAAS in performing the audits of local educational agencies.

Firm's Response

The procedures were performed, however you found little documentation. We feel it is harsh to indicate our report is incorrect because we did not perform the audit in accordance with GAAS and GAGAS. AU Section 339, SAS 96, is effective for audits of financial statements for periods beginning on or after May 15, 2002. This was understood to not apply to the year beginning July 1, 2001 that was the subject of your review.

There was sufficient documentation of financial statement items in most areas which exceeded the five compliance matters you reported, however that is not mentioned.

SCO's Comment

The firm's working papers did not contain sufficient documentation of K-12 Audit Guide procedures performed to ascertain from them evidence that supported the auditor's judgments or conclusions. The report should be supported by the audit working papers, which should document the auditor's judgments or conclusions. If the working papers do not support the report, the report may be incorrect. The working papers as reviewed did not provide assurance that the audit had been performed in accordance with GAAS and GAGAS.

The firm is correct in its observation of AU Section 339, as it pertains to SAS 96. The SCO inadvertently used language as it pertains to SAS 96, rather than SAS 41, which covers the audit period being reviewed. However, the basic intent of AU Section 339 did not change and still applies to the auditor's work. The correct AU Section 339 criteria citations are as follows:

AU Section 339.01 states:

The auditor should prepare and maintain working papers, the form and content of which should be designed to meet the circumstances of a particular engagement. The information contained in the working papers constitutes the principal record of the work that the auditor has done and the conclusions that he has reached concerning significant matters.

AU Section 339.02 states:

Working papers serve mainly to—
a. Provide the principal support for the auditor's report, including his representation regarding observance of the standards of field work, which is implicit in the reference in his report to generally accepted auditing standards.
-b. Aid the auditor in the conduct and supervision of the audit.

Additionally, the finding, as written, refers to K-12 Audit Guide deficiencies, not financial statement deficiencies.

The finding remains as written.

FINDING 4— Quality control deficiencies

The firm did not meet GAGAS standards for internal quality controls because it had no internal quality control system in place.

GAGAS 3.31 states:

Each audit organization conducting government audits in accordance with these standards should have an appropriate internal quality control system in place and undergo an external quality control review.

GAGAS 3.32 states:

The internal quality control system established by the audit organization should provide reasonable assurance that it (1) has adopted, and is following, applicable auditing standards and (2) has established, and is following, adequate policies and procedures.

Without an appropriate internal quality control system, the firm may not be following all applicable auditing standards. The audit report may contain incorrect assertions and statements due to the firm's failure to conform to auditing standards. The report deficiencies noted in Finding 5 are an example of why an internal quality control system is important.

Recommendation

The firm should establish policies and procedures to ensure all audits are conducted in accordance with GAGAS standards.

Firm's Response

Your report indicates we had no internal quality control system in place.

We have a quality control system and have undergone a peer review every three years. Our system was established in 1988.

SCO's Comment

This finding discusses only the internal quality control standards and requirements and does not state that the firm is deficient in the requirements for an external peer review every three years. Based on review work performed during the quality control review and discussions with the firm, no documentation of an internal quality control system was provided. Since the review was conducted in the firm's office, no additional documentation has been provided by the firm regarding its internal quality control system. GAGAS 3.32 requires an internal quality control system to not only have been adopted, but to be operating and following adequate policies and procedures.

The finding remains as written.

Noncompliance With Reporting Standards for Financial Audits (GAAS and GAGAS)

FINDING 5— Deficiencies in reporting and due professional care

The firm did not consistently practice due professional care when preparing the audit report. The SCO's review of the audit report disclosed:

- The firm's schedule of audit findings and questioned costs stated that the type of auditor's report issued on compliance for major programs was unqualified. However, an auditor's report on compliance for

major programs was not issued because a single audit in accordance with OMB A-133 was not required.

- In paragraph 4 of the auditor's opinion letter, the firm cites "... the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year ended. . . ." This language was included even though the district had no proprietary or nonexpendable trust funds.

AU Section 230.02 states:

This standard requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of fieldwork and reporting.

GAGAS 3.28 states:

Exercising due professional care means using sound judgment in establishing the scope, selecting the methodology, and choosing tests and procedures for the audit. The same sound judgment should be applied in conducting the tests and procedures and in evaluating and reporting the audit results.

The audit report contains information that is incorrect, not supported by the working papers, and may mislead users of the audit report.

Recommendation

The firm should exercise greater care in preparing the audit report and review the report prior to issuance for accuracy.

Firm's Response

The items indicated were in the report and should not have been. However, we feel you are using very negative language for items that though in error, are not major deficiencies. We do review our reports prior to issuance and feel there are very few problems such as this. The school district reports are lengthy and it is unfortunate that this oversight occurred.

SCO's Comment

Whether the firm believes the errors are major deficiencies or not, the audit report contains incorrect information. Consequently, users of the audit report may be misled by the incorrect information.

The finding remains as written.

**Attachment—
Firm's Response to Draft Report**



August 10, 2004

Casandra Moore-Hudnall, Chief
Financial Audits Bureau
State Controller's Office
Post Office Box 942850
Sacramento, CA 94250-5874

Dear Ms. Moore-Hudnall:

We feel it is unfair to report that the majority of auditing standards and requirements were not met. Your report is written in a much more negative tone than I recall the exit conference discussion. We performed the audit in accordance with auditing standards, and you seem to not consider materiality in some of your examples. With that said, here is our response to certain items.

Finding 1-Payroll not tested and service organization not considered

The finding, for the year ended June 30, 2002, is correct.

Finding 2-Sampling deficiencies

We did not document the sampling methodology; however, we used professional judgment in the testing. The district is small and for attendance, for example, we tested a representative sample of teachers and grades. For the balance sheet and revenue accounts, we did no sampling as we audited the details.

Finding 3-Evidential matter deficiencies

The procedures were performed, however you found little documentation. We feel it is harsh to indicate our report is incorrect because we did not perform the audit in accordance with GAAS and GAGAS. AU Section 339, SAS 96, is effective for audits of financial statements for periods beginning on or after May 15, 2002. This was understood to not apply to the year beginning July 1, 2001 that was the subject of your review.

There was sufficient documentation of financial statement items in most areas which exceeded the five compliance matters you reported, however that is not mentioned.

Finding 4-Quality control deficiencies

Your report indicates we had no internal quality control system in place.

We have a quality control system and have undergone a peer review every three years. Our system was established in 1988.

Finding 5-Deficiencies in reporting and due professional care

The items indicated were in the report and should not have been. However, we feel you are using very negative language for items that though in error, are not major deficiencies. We do review our reports prior to issuance and feel there are very few problems such as this. The school district reports are lengthy and it is unfortunate that this oversight occurred.

For your information, we are no longer performing audit services for school districts. Please contact me if you have any questions.

Sincerely,



Gary S. Jones, CPA

**State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, California 94250-5874**

<http://www.sco.ca.gov>